# FOREIGN DOMICILIARIES - CURRENT DEVELOPMENTS

BRIEFING

July 2017

## Introduction

In our May 2017 publication "An unwelcome bolt from the blue!" we explained that as a result of the Snap General Election all of the provisions relating to foreign domiciliaries which were in the Finance Bill published on 20 March 2017 (which were due to come into effect from 6 April 2017) were dropped from the initial Finance Act 2017. There was a commitment on the part of the then Government to reintroduce them as soon as possible, but no further details were provided at that time.

The political uncertainty following the election result diverted the Government's attention to other priorities and it has taken longer for the position with respect to the reintroduction of the provisions to be clarified (although the Queen's Speech provided some general details). A Ministerial Statement was released on Thursday 13 July. This stated that the Government expected:

- That all the changes which had been dropped from the first Finance Bill 2017 would be introduced in a second Finance Bill that would be published as soon as possible after the summer recess (the House rising on 20 July and returning on 5 September to rise again on 14 September for the Conference season, to return on 9 October);
- That where policies had been announced as applying from the start of 2017/18 or any other point prior to the publication of the second Finance Bill, those effective dates would still apply;
- That where there are to be changes to the dropped 20 March 2017 provisions in the second Finance Bill which will be effective prior to publication of the second Finance Bill, the draft legislation would be published (this too occurred on 13 July 2017).

This publication summarises the changes to the taxation of foreign domiciliaries, as we currently understand them to be.

## Overview of the provisions to be enacted

The changes to be enacted amount to the most significant package of measures affecting foreign domiciliaries since 2008, particularly as they cover the Remittance Basis and Inheritance Tax (IHT).

The main changes can be summarised as follows:

1. Anyone born in the UK with a UK domicile of origin (defined as a "Formerly Domiciled Resident" or "FDR") who is UK resident in a tax year will be deemed domiciled in the UK for all tax purposes (subject to a period of grace for IHT if the individual was not UK resident in either of the preceding two tax years);
2. A long term resident – one who has been UK resident in at least 15 of the

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immediately preceding 20 tax years – will be deemed domiciled for all tax purposes;

3. The scope of IHT will be extended so as to apply to:
    - UK residential property owned by foreign domiciliaries (or trusts settled by foreign domiciliaries) through a foreign company or partnership;
    - relevant loans (broadly a loan where the funds are used for the acquisition, maintenance or enhancement of an interest in UK residential property); and
    - collateral on the relevant loan.

Despite calls for de-enveloping relief (to mitigate or defer taxes in unwinding structures rendered ineffective) in the wake of the extension of the IHT announcement, the Government declined to introduce any such legislation.

There are, however, the following reliefs/protections:

- Capital Gains Tax (CGT) rebasing relief on assets held directly by individuals (it is understood that this also includes partnership assets), to apply to income gains realised on non-reporting funds as well as on all capital gains on foreign assets. This works by allowing base cost uplift to 5 April 2017 market value, providing relief for individuals (who were not FDRs) who became long term resident for the first time in 2017/18 provided they met certain other conditions (see our Reforms to the Taxation of Foreign Domiciliaries publication for the conditions).
- A special cleansing relief for individuals who have been remittance basis users in at least one tax year between 2008/09 and 2016/17 (apart from FDRs) with mixed fund bank accounts (again see our Reforms to the Taxation of Foreign Domiciliaries publication for the details).
- Protections for settlor-interested trusts where the settlor is a long-term resident (and not an FDR). The protections are as follows:
    - the CGT anti-avoidance provision that would otherwise automatically attribute trust gains to a UK domiciled settlor but was switched off for a foreign domiciliary will continue to be disapplied, even though the individual is deemed UK domiciled, provided the trust does not become tainted (that is, there are no non-qualifying additions – this is a complex area and you should discuss it with your usual Rawlinson & Hunter contact to make sure you do not inadvertently taint your trust and lose valuable protections).
    - broadly the income tax anti-avoidance legislation that would subject the settlor to a tax charge on the trust's foreign income as if it were his own is to be disregarded. This will in certain cases be very helpful, as it means that the trustee (who is a "relevant person" in connection with the settlor) can from 6 April 2017 use the trust's foreign income in the UK without resulting in a taxable remittance for the settlor. Again, tainting of the trust by non-qualifying additions would cause a loss of the protection so advice should be taken.

A limited number of relaxations to Business Investment Relief (BIR) are also to be introduced to encourage greater investment in the UK (again see our Reforms to the Taxation of Foreign Domiciliaries publication for the details).

The HMRC/HM Treasury Response Document and draft legislation released in December 2016 indicated that the changes were to be even more far reaching (as discussed in our January 2017 publication "Update Reforms to the Taxation of Foreign Domiciliaries"). Broadly the following additional changes were proposed at that time:

- Transfer of the income tax benefits charge to the settlor where the beneficiary in receipt of the benefit is a close family member of the settlor.
- A 're-cycling' rule under the CGT anti-avoidance provisions and two Income Tax anti-avoidance codes, intended, broadly, to prevent avoidance of UK tax through trust distributions to beneficiaries who are not taxable in the UK on the distributions, but who then make onward gifts to individuals who would have been taxed in the UK.
- Transfer of the CGT attribution benefits charge to the settlor where the beneficiary is a close family

member who is not taxable on the benefit.

- Various CGT anti-avoidance provisions intended to prevent the washing out of trust gains through payments to migrating beneficiaries and non-UK residents.

In the end it was decided that more time was required to work on these complex changes and the clauses were dropped from the 20 March 2017 Finance Bill, with the suggestion that they would be refined and introduced in a subsequent Finance Act. They do not appear in the draft legislation released for the second Finance Bill 2017. There was, however, an oral question in the House of Commons on 18 July by the Labour MP Catherine West (Hornsey and Wood Green) (Lab), which drew the following response from The Financial Secretary to the Treasury (Mel Stride):

> *"The UK has effective legislation to tackle avoidance involving offshore structures and we have announced our intention to legislate further, making it harder for non-doms to avoid paying tax on funds withdrawn from trusts. I am also pleased to say that we have been at the forefront of international work that has seen 100 countries commit to exchange financial information automatically."*

It may therefore be that the changes will be introduced in Finance Bill 2018.

## Changes in the July 2017 draft legislation

### *Cleansing*

The original announcements with regard to mixed account cleansing were interpreted by those outside of HMRC/HM Treasury to mean that cleansing would be available whenever the funds arose. It became clear, however, when the draft clauses were discussed with interested parties that HMRC was interpreting them more narrowly as relating just to funds credited after 5 April 2008.

Representations were made and the Chancellor announced that cleansing would also be available for pre 6 April 2008 funds. The 20 March 2017 Finance Bill did not include the necessary provisions and it was understood that there would be a Committee Stage amendment. The draft legislation published on 13 July 2017 includes the clauses which allow for cleansing of pre 6 April 2008 funds.

### *Trust protections*

Various technical changes have been made, including:

- amending the legislation where there were drafting issues (such as introducing a consequential amendment to ensure that the new rules do not negate the Pre-Owned Asset Tax rules); and
- clarifying the legislation so as to make it clear that the test for protected foreign source income is applied in the year for which the income actually arises.

### *Extension of IHT to UK residential property, relevant loans and collateral on relevant loans*

Various technical changes have been made, generally aimed at blocking perceived weaknesses in the original legislation such as:

- a new sub-section which clarifies that when determining whether a person's interest in a foreign company or partnership holding one of the above assets passes the 5% de minimis test (such that the legislation does not apply) one must treat their interest as being increased by the interests of all persons connected to them; and
- provisions which clarify that references to a debt include any arrangement where a debt arises, not just those situations where a person has acknowledged the debt.

## Next steps

The language of the Ministerial Statement clearly committed the current Government to the changes as announced and the likelihood is that, apart from some further minor technical amendments, the legislation will be passed as released in draft on 13 July 2017. However, we have a hung Parliament, so the Government does not have the usual leverage when it comes to voting matters. We cannot rule out the possibility of:

- specific provisions being rejected or significantly amended; or
- further political upheaval (such as another General Election) that could throw the second Finance Bill process into disarray.

Assuming there are no further delays, the second Finance Bill should be on the statute book in mid to late November (seven months into the tax year). This will depend on whether the Finance Bill can be published and debates started before the House rises on 14 September for the Conference season.

The extremely late date for Royal Assent combined with the retrospective nature of the legislation may present practical issues for those dealing with the affairs of deceased individuals and for trusts affected by either:

- IHT deemed domicile; or
- the extension of IHT to UK residential property, relevant loans and collateral related to relevant loans.

This is best explained by way of examples:

1. An FDR has been UK resident for the last ten tax years so does not benefit from the "period of grace". Thus under the new rules to be enacted, his worldwide assets and all the assets held by trusts which he has settled are subject in full to UK IHT. The FDR died on 7 April 2017. Under the law as it is currently, all foreign property is exempt from IHT as excluded property. When the second Finance Bill is enacted, his foreign assets, which were exempt from IHT under the law in force at the date of death, will have retrospectively become chargeable.
2. An individual who is a foreign domiciliary died on 17 April 2017 owning the shares in a foreign company that just owns a UK residential property. The current rules apply and it is excluded property which is exempt from IHT (the company being an effective blocker). When the second Finance Bill is enacted, an asset which was exempt from IHT under the law in force at the date of death has retrospectively become chargeable.

Whilst the changes were announced as far back as Summer 2015, to avoid the above types of situation one really does wonder whether it would be better to defer the start date for the IHT legislation until 6 April 2018. There seems very little likelihood of the Government agreeing to that, though.

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